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United States Department of Energy Loan Guarantee Program

Comments in response to Notice of Proposed Rulemaking on Loan Guarantees for Projects that Employ Innovative Technologies (RIN 1901-AB21), 72 Federal Register 27471 (May 16, 2007)

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Introduction

We are pleased to provide the United States Department of Energy ("DoE") with feedback on its above referenced Notice of Proposed Rulemaking ("NOPR") for the loan guarantee program authorized under the 2005 Energy Policy Act. It is clear that much thought and hard work has gone into preparing the NOPR and it is therefore our hope that the suggestions contained herein can assist the DoE in structuring a successful program.

As you know from our previous discussions, Citi's Export and Agency Finance ("EAF") team is highly experienced in the structuring of financings utilizing government guarantees, and is therefore uniquely qualified to provide insight to the DoE in terms of best market practices for its new program. The highlights of this experience include:

- Citi's longstanding position as the #1 lead arranger of U.S. Eximbank guaranteed financings.
- Citi has servied as lead arranger and/or lender for five out of the six transactions guaranteed by the Air Transportation Stabilization Board and serving as a key catalyst in the development of the program.
- Citi has partnered with the Overseas Private Investment Corporation ("OPIC") in building innovative financial solutions involving OPIC's insurance and guarantee products.

We have based our feedback provided herein on the current information available regarding the DoE's loan guarantee program and our view of current market conditions. We would be pleased to discuss or expand upon the discussion below at any time; please feel free to contact Antonia Schwartz, Vice President of Citi's Export and Agency Finance Group, at +1 212 816 1871 or antonia.schwartz@citigroup.com with any questions. Again, thank you for the opportunity to provide this feedback on the program and we look forward to working together with the DoE towards a successful program implementation.

Summary of Major Issues in NOPR

There are a significant number of requirements included in the NOPR, as drafted, that we believe will render the loan guarantee program unable to deliver an efficient financing. Several provisions that we believe were designed to assure adequate due diligence of projects severely and unnecessarily limit investor interest and thereby increase costs. In the worst case, the high costs and onerous application procedures can lead to an adverse selection of projects that are presented to the DoE as the more market friendly transactions seek financing elsewhere. The most significant issues, in our opinion, are:

Issue	**Comment**
Partial Guarantee	Unguaranteed co-financing of commercial lenders may or may not be available depending on individual project characteristics. This requirement gives rise to the next two points, which may significantly increase a project's total cost.

Subordination of Clean Debt	Subordinated unguaranteed co-financings will likely be viewed as quasi-equity (with limited market depth) and therefore can attract significant cost.
Hybrid Instrument	By requiring that the guaranteed lender retain the non-guaranteed portion of project debt on a pro rata basis, the DoE is limiting its investor base.
Guarantee Conditionality	Making the availability of the DoE guarantee contingent upon the performance of non-market responsibilities by the lender can result in inefficient pricing of the government guarantee and lower levels of interest from traditional investors in AAA paper.
Application Process is Unbalanced	The application process requires sponsors to submit certain commitments and reports at a time in the application process when these documents are unlikely to be available.

Below, we elaborate on these points in more detail.

Requirement and Treatment of a Commercial Co-Financing

The DoE's intent to guarantee no more than 90% of the debt in any one project creates numerous difficulties and introduces avoidable costs. The two most pressing issues are subordination of the clean tranche and the 'stapling' of the tranches.

1. **Subordination**: Commercial lenders who typically invest in senior debt cannot be subordinated to the DoE. For those investors the guaranteed and clean tranches must rank, at a minimum, pari-passu with respect to both payment and collateral. If the commercial tranche must be subordinated, it will likely be viewed as quasi-equity with a commensurate reduction in this market's capacity to provide this financing and substantial increase in cost.

   Equity or quasi-equity investors have a different view of risk and return trade-offs relative to senior lenders.

2. **Stapling**: The requirement that all lenders hold a portion of the guaranteed tranche and the clean tranche significantly limits the investor base that would participate in DoE-guaranteed financings. Especially where the unguaranteed tranche is subordinated, very different investors would be interested in holding the two tranches of the facility. Funders of high-quality (AAA), government-guaranteed paper do not invest in quasi-equity, in the same pool of investments. Even where the commercial tranche ranks pari passu to the DoE guaranteed funding, the most efficient funding will come from two separate investor bases. Limiting the funding sources will significantly, if not prohibitively, increase the project costs.

3. **Additionality**: The DoE may support projects on a wide scale of commercial and technological risk. The availability of a clean risk financing will depend on where a project

is located on this risk spectrum. At the safer end, it is conceivable that commercial lenders can finance a portion of the project. However, for projects the DoE may want to support for policy reasons, the financial markets may not be ready to accept any exposure.

4. **Capacity**: Some projects eligible for DoE support require very large investments, such as IGCC and nuclear power plants. For a very large project, even 10% of the total debt can amount to significant sums that may exceed the market's capacity for clean risk, in particular if the market is limited by the hybrid nature of the guarantee .

5. **Terms**: The commercial and guaranteed tranches cannot carry the same terms. This is especially true if the commercial financing is subordinated, as the two tranches would bear significantly different risk. The differences would likely be expressed in pricing, but also in tenor and inter-creditor rights. Subordinated investors, in particular, will likely require a measure of control over decision making, that the DoE may not find attractive.

Adequate Due Diligence

We are sympathetic to the DoE's goal to protect the taxpayer and to ensure an appropriate level of project due diligence by forcing lenders to have capital at risk. We do, however, believe that the proposed regulations create unwarranted costs to the projects since lenders are not the best parties to assume due diligence risk.

Adequate due diligence and therefore reasonable assurance of repayment can be achieved through:

1. **Substantial Equity Contribution**. Project sponsors, who invest in a first loss position, are key to project due diligence. Experienced sponsors with significant investments provide the most focused and technologically competent assessment of projects, as they are the day-to-day managers of the construction and operation. A significant equity requirement will ensure that sponsors interests are aligned with that of the DoE

2. **Expert Advice**. The lead arranger of a financing will typically co-ordinate the due diligence process, while lenders and the DoE would review and assess the results. The DoE could further supplement said due diligence by engaging its own third-party experts where necessary. Agencies such as OPIC and the Export-Import Bank have successfully used this approach. In the project finance market, lenders invariably retain (at the cost of the borrower) outside legal, technical and other consultants to perform the due diligence that the government is correctly focused on.

Guarantee Conditionality

The DoE guarantees must be absolutely unconditional and viewed as "AAA" credit quality by the major rating agencies and lenders. This means that once a guarantee is issued, there can be no reason until after the maturity date that it would not be fully enforceable.

1. **Exceptions**: We do not believe that the exception for fraud or material misrepresentation by the holder of the guarantee as proposed in the NOPR is necessary.

2. **Duty of Care**: The NOPR seeks to impose on lenders a duty of care and other duties that are significantly more onerous than is required in other federal loan guarantee programs. The effect of these provisions is to make the guarantee conditional and to put lenders at risk disproportionately to potential returns. Lenders could take the view that the guarantee is too conditional and that the DoE is not truly taking the project risk.

   Especially collateral agents, indenture trustees or other agents, who usually act for and at the direction of lenders or bond holders and who receive minimal compensation, will require protection from liability in the documentation. The final regulations should reflect this market practice.

3. **Audit**: The concept of after-the-fact audits and exclusion or reduction of project costs based on such audits is inconsistent with market practice in project finance transactions and will render the guarantee unacceptably conditional. Requests for funding of project costs should be reviewed by the independent engineer as part of the normal construction loan draw process, and once approved and drawn, should be binding under the guarantee.

These care requirements can substantially reduce interest in the lender community in the loan guarantee program and therefore limit the availability of funding.

Application Process

We believe that the application process can be further streamlined to allow for efficient review of applications while avoiding unnecessary expense by the project sponsor early in the transaction.

1. **Application in response to solicitation**: By accepting applications only in response to a particular solicitation, the DoE loan guarantee process would be unduly prejudicial to projects that happened to have matured sufficiently to produce the required pre-application materials in the narrow timeframe of a solicitation. The final regulations should clarify that the DoE would accept and review applications for eligible projects at any time when sponsors believe that the markets are ready for their investment. This would not preclude the DoE from opening or closing the program for specific technologies at various times.

2. **Lender's commitment letter**: The pre-application stage is, in our view, too early to request a commitment from lenders. To issue such a letter, the lenders would be required to complete their due diligence and credit approvals, including receipt and review of consultant reports prior to the first review by the DoE. We believe that the DoE may want to influence the due diligence, for example by selecting consultants or defining their scope of work in conjunction with the lenders. We recommend that the DoE request only a mandate letter from the lead arranger at the time of the pre-application.

3. **Application fee**: The final regulations should clarify that the application fee or first fee is only payable if the sponsor elects to submit an application in response to the DoE's invitation to do so.

4. **Documentation**: The requirement to draft all documents, including financing documents, prior to submission of an application is in our view too onerous and does not reflect practice of other federal guarantee programs. Since the drafting of documents is time-consuming and expensive, it is typically started only after completion of due diligence and approval of a

transaction by all parties. In addition, the DoE may wish to be involved in the negotiation of documents from the beginning, rather than be presented with almost final finance documents.

5. **Rating**: We question the value of requiring a rating for each transaction, which are time-consuming and costly to obtain. In any event, we suggest that such a review not be made a prerequisite of an application, since transaction structures often change during the due diligence and review process by all investors, including the DoE. The rating, if any, should reflect the final project structure, not the initial proposal by the sponsor.